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MEMORANDUM

AS TO

GRADUATED CORPORATION INCOME TAX

AND

INTERCORPORATE DIVIDEND TAX

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OCT 24 1939
TREASURY DEPARTMENT

By

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GRADUATED CORPORATION INCOME TAXES

The President's Tax Message of June 29, 1935 says:

> "I, therefore, recommend the substitution of a corporation income tax graduated according to the size of corporation income in place of the present uniform corporation income tax of 13 3/4 per cent. The rate for smaller corporations might well be reduced to 10 3/4 per cent, and the rates graduated upward to a rate of 16 3/4 per cent on net income in the case of the largest corporations, with such classifications of business enterprises as the public interest may suggest to the Congress.

This recommendation involves decreases as well as increases and a table of rates roughly complying with this recommendation and estimated to yield $102,200,000 in revenue is taken for the purpose of illustration as follows:

Graduated Tax on Corporation Income
Estimated increase in revenue $102.2 millions

Income bracket (in thousands of dollars)	Rate (per cent)	Total tax 1/ (in dollars)	Percentage of tax to total taxable income 1/
Up to 2	10	200	10
2 - 15	13½	1,955	13.03
15 - 40	14	5,455	13.64
40 - 100	15	14,455	14.46
100 - 300	16	46,455	15.49
300 - 1,000	17	165,455	16.55
Over 1,000	17½		

1/ Computed on upper limit of brackets.

Upon the basis of our estimate of corporation incomes for the calendar year 1935, 182,000 corporations, or 95 per cent of all of those expected to report net incomes for this year, would pay a smaller tax under such a schedule than under the flat rate now in effect.

It is apparent, therefore, that the proposal of the President in addition to producing additional revenue involves a redistribution of the corporation tax burden by which 95 per cent, of all corporations, obtain some tax relief, and about 5 per cent, consisting of the largest corporations, would sustain an additional burden.

Such a shifting of the burden would produce desirable consequences from many standpoints.

A weakness of our income tax structure revealed by the depression is the violent fluctuation of Government revenues resulting therefrom. It is apparent that if we can combine a tax based on ability to pay with increased reliance for revenues upon that class of corporations whose income is most stable, and decrease our reliance for revenues upon those corporations whose income shows the greatest fluctuation, we move in the direction of stabilizing the revenues and evening out fluctuations.

It, therefore, becomes of importance to know whether there is a difference in the stability of the income between large and small corporations. The information is not adequate to give conclusive finality. Our latest complete figures are for 1932 and do not therefore cover the whole depression cycle. So far as available the information seems to receive a pretty generally agreed interpretation.

The National Industrial Conference Board, in a study dated July 19, 1935 which recommends against this tax, nevertheless advances the following significant conclusions:

> "The most significant conclusion suggested by this table is that the larger corporations showed more stability than the small corporations under the adverse conditions of 1931 and 1932. In the income group the small corporations reported the largest profit ratios, while in the no-income or deficit group they sustained the heaviest losses. The variation in the ratios among the size classes was considerably larger for the no-income group than for the income group, hence the relatively larger losses for the smaller corporations when both groups are combined."

The Board supports the conclusion with figures taken from the Treasury Department's Statistics of Income. The Treasury Statistics of Income for 1932, show that the statutory net deficit of corporations of less than $50,000 of assets constituted 33 per cent of their net worth, and that the percentage deficit was progressively smaller for each succeeding group of larger corporations:

Per Cent of Statutory Net Income or Deficit to Net Worth of Corporations Classified by Size of Total Assets, 1932.

Asset Classes (thousands dollars)	Percentage of Statutory Net Deficit
ALL CORPORATIONS	
Under 50	-33.0
50 - 100	-14.0
100 - 250	-10.0
250 - 500	- 7.6
500 - 1,000	- 6.9
1,000 - 5,000	- 5.7
5,000 - 10,000	- 5.1
10,000 - 50,000	- 3.8
50,000 and over	- 1.1
Total	- 3.9

The National Industrial Conference Board also made a study of 1931 corporation income tax returns and arrived at substantially similar conclusions. In a bulletin dated March 20, 1934, the Board shows for manufacturing corporations alone not only that "the statutory net deficit in operations of 1931 was relatively greatest in the smallest corporations"; but that "the proportionate deficit to gross sales is seen to have become gradually smaller, except in one class, as assets increased in size, and among the largest corporations, the deficit disappeared altogether, having been replaced by a relatively small net income." The Board further found, in considering manufacturing corporations alone by asset classes:

> "When the results of manufacturing operations are related to the capital stock and surplus, the ratio of deficit to the size of assets is very striking. In the smallest corporations, the deficit was 25.6 per cent of the book value and exceeded 10 per cent in the next class above this. The proportion dwindled from this point to 0.4 per cent in corporations with assets of $10 million to $50 millions, while the largest corporations showed profits of 2.1 per cent."

Two tables summarizing these points follow:

Manufacturing Corporations by Asset Classes
Gross Sales and Net Deficit, 1931

Amounts in million dollars

Asset Classes Thousand dollars	Gross Sales	Statutory Net Deficit	
		Amount	Percent of Gross Sales
Under 50	1,437	105	7.3
50 - 100	1,348	68	5.0
100 - 250	2,625	125	4.8
250 - 500	2,474	106	4.3
500 - 1,000	2,717	98	3.6
1,000 - 5,000	6,256	240	3.8
5,000 - 10,000	2,529	55	2.2
10,000 - 50,000	6,505	116	1.8
50,000 and over	15,541	1/	1/
Total	41,433	770	1.9

1/ Corporations in this group made a net income of $141 million which was 0.9 per cent of the gross sales.

Manufacturing Corporations by Asset Classes
Capital and Deficits, 1931

Amount in million dollars

Asset Classes Thousand dollars	Capital stock and Surplus	Deficit	
		Amount	Percent of Capital stock and surplus
Under 50	407	104	25.6
50 - 100	582	67	11.5
100 - 250	1,494	122	8.2
250 - 500	1,774	101	5.7
500 - 1,000	2,334	91	3.9
1,000 - 5,000	6,785	209	3.1
5,000 - 10,000	3,283	38	1.1
10,000 - 50,000	8,888	36	0.4
50,000 and over	22,092	1/	1/
Total	47,640	308	0.6

1/ Corporations of this group had net profits amounting to $460 million or 2.1 per cent of their capital stock and surplus.

The National Bureau of Economic Research on April 18, 1934, called attention to the fact that, when corporations are grouped according to the value of their assets, no group earned an aggregate net profit in 1931 except the group whose assets exceeded $50 millions. These concerns (not including subsidiaries) numbered only 632 out of the 381,000 corporations included in the study. But, with their subsidiaries, they owned more than 50 per cent of the total assets reported by the 381,000 corporations -- $155 billions out of the total of $296 billions. Further, the Bureau called attention to the fact that there was an impressive relationship between size of corporations and relative smallness of losses -- the group of smallest corporations experiencing the greatest percentage deficit. This study is summarized in the following table:

Earnings of Corporations in the United States 1/ 1931

Classified by Size

Size (total net assets in thousands of dollars)	Number of reporting corporations	Aggregate net profits after tax (in millions of dollars)	Aggregate net profits after tax, relative to total stock equity (per cent)
Under 50	182,447	- 415	- 21.7
50 - 100	61,144	- 218	- 9.1
100 - 250	63,428	- 353	- 6.5
250 - 500	31,052	- 268	- 4.6
500 - 1,000	19,335	- 271	- 3.9
1,000 - 5,000	18,345	- 591	- 3.0
5,000 - 10,000	2,588	- 166	- 1.8
10,000 - 50,000	2,117	- 104	- 0.5
50,000 - and over	632	1,507	+ 2.2

1/ Excluding corporations not reporting balance sheets.

Source: "Recent Corporate Profits in the United States," by Solomon Fabricant (Bulletin No. 50, National Bureau of Economic Research, April 18, 1934).

Similarly, Professor W. L. Crum of Harvard University, in a study entitled "The Effect of Size on Corporate Earnings and Condition", published in June 1934 by the Bureau of Business Research of the Graduate School of Business Administration of Harvard University, concluded, on the basis of 1931 returns:

"The most striking finding of the above analysis, with reference to corporate earning power, is the fairly general tendency for larger corporations to have a higher average return on their gross business than smaller corporations.

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"Although this tendency does not appear without exception in all divisions and groups, and is accompanied with some irregularities even in various groups where it does appear, it is so common in the cases examined that there is ample reason for regarding it as a roughly general rule."

Professor Crum also declared:

"The second finding of chief significance is that, in general, large corporations had a smaller rate of loss on their net worth in 1931 than did smaller corporations."

Another finding by Professor Crum is significant:

"Among the other subordinate ratios, one of the most significant studied is the ratio of current assets to current liabilities. Examination of this ratio shows that the current position of larger companies was emphatically better than that of smaller companies for most lines of industry in 1931."

The Treasury, in the light of information now available, is of the opinion that the graduated income tax proposed by the President, which will base revenue yield more upon larger and less upon smaller corporations, would produce a more reliable, predictable and steady flow of revenue to the Government than the present flat rate of tax for all.

It also believes that such larger corporations are, by reason of their more stable revenues, better able to anticipate and bear the burdens than smaller corporations whose incomes tend to fluctuate more erratically.

However, even though it is desirable to tax big corporations at a higher rate than little corporations, from a revenue view point, the proposal would need examination as to its secondary consequences and as to the underlying economic conditions on which the proposal would operate.

Concentration of corporate assets in this country today can be determined with a fair degree of accuracy from Treasury statistics. Only those corporations which failed to submit income tax returns or failed to include balance sheets with their returns are omitted from our studies, and they are too insignificant to affect the result substantially. In 1932, the number submitting balance sheets was 392,021, and they reported total assets owned of $280,085,000,000.

The degree of concentration of assets revealed is startling. Over 53 per cent of the value of all assets owned by corporations in this country was owned by 618 corporations, constituting only .2 of 1 per cent of the number of corporations. At the lower extreme the percentage of assets owned is equally significant. Sixty-seven and six-tenths per cent of all American corporations held only 2.9 per cent of the aggregate corporate assets. I have said that the percentage of corporations whose tax would be increased, by application of the President's message, would be only 5 per cent of the total number reporting. We find that 5 per cent of the corporations owned 85 per cent of all the wealth owned by corporations in 1932. The 5 per cent owning the 85 per cent of the

corporate wealth and the 5 per cent whose taxes would be increased are not necessarily identical, but most of the corporations in one class will also be found in the other. A table shows the details of the distribution of assets among corporations of various sizes as follows:

All Corporations Filing Balance Sheets with Returns in 1932,
Distributed by Amount of Total Assets

Assets class (thousands of dollars)	Number of returns			Total assets (millions of dollars)		
	Number in class	Number cumulated	Percent cumulated	Amount in class	Amount cumulated	Percent cumulated
Under 50	206,477	392,021	100.0	3,870	280,083	100.0
50 - 100	58,320	185,544	47.3	4,153	276,213	98.6
100 - 250	59,500	127,224	32.4	9,414	272,060	97.1
250 - 500	28,422	67,724	17.3	9,988	262,646	93.8
500 - 1,000	17,590	39,302	10.0	12,289	252,658	90.2
1,000 - 5,000	16,705	21,712	5.5	34,432	240,369	85.8
5,000 - 10,000	2,442	5,007	1.3	16,857	205,937	73.5
10,000 - 50,000	1,947	2,565	.7	39,839	189,080	67.5
50,000 and over	618	618	.2	149,241	149,241	53.3

We turn now to a study of degree of concentration of net income reported by corporations for the year 1932. For this purpose, corporations which failed to have net profits are dropped out of the calculations and we have left, as the basis for the study, 73,291 corporations which reported a net profit and filed balance sheets with their returns.

Of all net income enjoyed by corporations during 1932, 50.4 per cent went to 201 corporations which represented only .3 of 1 per cent of the number of corporations having some net income. On the other hand, at the other extreme, 45 per cent of such corporations had less than 2 per cent of the total income. The details of corporate income by asset classes of corporations is set forth in the following table:

All Corporations Reporting Net Income in 1932 and Filing Balance Sheets with Returns, Amount of Compiled Net Profit Distributed by Total Assets Classes

Assets class (thousands of dollars)	Number of returns			Compiled net profits (millions of dollars)		
	Number in class	Number cumulated	Percent cumulated	Amount in class	Amount cumulated	Percent cumulated
Under 50	33,512	73,291	100.0	44	2,697	100.0
50 - 100	11,726	39,779	54.3	40	2,653	98.4
100 - 250	12,610	28,053	38.3	89	2,613	96.9
250 - 500	6,344	15,443	21.1	101	2,524	93.6
500 - 1,000	3,963	9,099	12.4	122	2,423	89.8
1,000 - 5,000	3,775	5,136	7.0	315	2,301	85.3
5,000 - 10,000	625	1,361	1.9	185	1,986	73.6
10,000 - 50,000	535	736	1.0	440	1,798	66.7
50,000 and over	201	201	.3	1,358	1,358	50.4

If we eliminate financial institutions, railroads and public utilities and other classes of business, and consider only manufacturing enterprises we find a similar degree of concentration. Of the total wealth owned by corporations engaged in manufacturing, 64.4 per cent was concentrated in the hands of .8 of 1 per cent of the number of corporations classified in that field. Manufacturing corporations with assets of ten millions and over constituted only 1.2 per cent of the total number of manufacturing corporations reporting net income, but this small group accounted for 63.3 per cent of the aggregate compiled net profits of all manufacturing enterprises as set forth in two tables as follows:

All Manufacturing Corporations Filing Balance Sheets with Returns in 1932,
Distributed by Amount of Total Assets

Assets class (thousands of Dollars)	Number of returns			Total assets (millions of dollars)		
	Number in class	Number cumulated	Percent cumulated	Amount in class	Amount cumulated	Percent cumulated
Under 50	40,901	82,113	100.0	785	59,023	100.0
50 - 100	12,539	41,212	50.2	897	58,238	98.7
100 - 250	13,021	28,673	34.9	2,065	57,341	97.2
250 - 500	6,506	15,652	19.1	2,290	55,276	93.7
500 - 1,000	4,043	9,146	11.1	2,797	52,986	89.8
1,000 - 5,000	3,887	5,103	6.2	8,090	50,189	85.0
5,000 - 10,000	587	1,216	1.5	4,096	42,099	71.3
10,000 - 50,000	512	629	.8	10,708	38,003	64.4
50,000 and over	117	117	.1	27,295	27.295	46.2

All Manufacturing Corporations Reporting Net Income in 1932 and Filing Balance Sheets with Returns, Amount of Compiled Net Profit Distributed by Total Assets Classes

Assets class (thousands of dollars)	Number of returns			Compiled net profits (millions of dollars)		
	Number in class	Number cumulated	Percent cumulated	Amount in class	Amount cumulated	Percent cumulated
Under 50	5,394	14,276	100.0	8	888	100.0
50 - 100	2,354	8,882	62.2	10	880	99.1
100 - 250	2,692	6,528	45.7	26	870	98.0
250 - 500	1,547	3,836	26.9	34	844	95.0
500 - 1,000	1,010	2,289	16.0	45	810	91.2
1,000 - 5,000	939	1,279	9.0	124	765	86.1
5,000 -10,000	163	340	2.4	79	641	72.2
10,000 -50,000	131	177	1.2	163	562	63.3
50,000 and over	46	46	.3	399	399	44.9

We find no evidence that a limit to the continued increase in corporate size has yet been reached, or that any real obstacle, economic or legal, to the continued concentration of corporate wealth has yet been created. By comparison between 1932 and 1926, we find that there was an increase in the concentration of corporate income. In 1926, 1.7 per cent of the total number of corporations reporting net income accounted for 69.8 per cent of the total of all corporations reporting net income. In 1932 it took only 1.1 per cent of the total number of corporations reporting net income to account for 72.6 per cent of the aggregate net income reported that year. The two years are not fully comparable and the figures therefore may reflect an increasing degree of concentration or they may simply be another evidence of the greater fluctuation in income of the smaller income group of corporations.

No condition is so favorable to corporate growth as profits. Profits both provide and attract capital. We may take the distribution of profits as a fair indication of prospects for growth. On that basis concentration and more rapid growth of the big companies in comparison with other companies, would appear to be a probable continuing process of our economic life.

There is substantial evidence that the depression, because of the greater stability of the larger units, has hastened the concentration of corporation owned wealth, at least in some industries, and especially in finance.

For example on December 31, 1929, one of the largest industrial cities in the United States had 72 banks, 8 of which were controlled by the dominant banking interests of that community, and 64 of which were controlled by other interests.

As of December 31, 1933, the 8 banks owned by the dominant group had all survived, whereas the 64 competitors had been reduced, through closings and mergers, to 33 and of those 20 corresponded or cleared through the dominant banks.

During that period the percentage of capital and surplus reported by the dominant group of banks had increased 31 per cent, while the percentage reported by their competitors within the city had decreased 38 per cent.

Deposits of the dominant banks increased 63 per cent, and those of competing banks decreased 45 per cent.

In the trade area outside of the same city on December 31, 1929, 19 banks in 17 towns dominated by the same banking interests had 30 banks as competitors. As of December 31, 1933 the dominant banks were all in business and the number of competing banks had decreased to 13 and the proportion of bank capital and deposits under the dominant group had increased accordingly.

The social implications of these facts will be read differently according to the temperament, view point and perhaps the interests of different observers. That such facts do have an important significance in weighing the merit of the secondary effects of the President's recommendations seems obvious, and from the Treasury's view point they point to a source of revenue to be drawn upon in accordance with ability to pay.

The ability to pay is, in our view, based in large part upon advantages which larger corporations have over smaller ones, so that increased levies upon the former would not only be based upon the theory of ability to pay, but would be based upon benefits received. While it is probably debatable whether size has not often exceeded the requirements of efficient operation, and whether in fact it has not sometimes been accomplished at the expense of efficiency, there can be little doubt that the greater stability, on the whole, of large corporations is attributable to their many advantages over their smaller competitors; and these advantages are reasons why size provides a useful measure of ability to contribute to the cost of government. Some of the more obvious advantages are

(1) As buyers of commodities and services, the large volume of their purchases gives the larger corporations a bargaining power that often results in price concessions which smaller concerns do not share.

(2) Through widely distributed branch plants and warehouses, they are able to effect important savings in transportation costs, and to sell in a nation wide market.

(3) Their large resources enable them to buy up important patents, often to pool these patents with those obtained by other large enterprises; and to carry on research programs, the fruits of which, while of public as well as private benefit, accentuate their competitive advantages over their smaller rivals.

(4) In many cases large concerns have become of such dominating size that they are able to control the markets for their products, enabling them to maintain prices that protect their profit margins.

(5) Large corporations possess distinct advantages over their smaller competitors in the facility and cost of financing, for they are able to tap the large reservoirs of capital that are made available through the organized financial markets.

The Treasury has studied the effect of a graduated corporation income tax upon the common share earnings of selected industrial corporations. It is difficult to learn the exact practical effect for the incomes reported for income tax purposes seldom agree with the earnings reported to stockholders. This is because corporations, for income tax purposes, do not include dividends received from non-consolidated corporations nor do they include tax-exempt interest. Often also, they take for income tax purposes depreciation and

depletion deductions greater than those made in reports to stockholders. Therefore, earnings available per common share, according to the income tax records, rarely agree with the same information from published reports.

The effect upon common share earnings of the graduated tax is not subject to any fixed rule but would depend upon the capital structure of the particular corporation. All earnings available for preferred as well as for common stock are subject to tax, and the tax would usually be paid by the common stock alone, since the preferred stocks are normally entitled to a fixed return, and the cost to common stockholders would therefore be greater in cases where preferred stock is outstanding.

Also in years of low earnings the amount of the tax per share would be lower, and when no taxable earnings were reported no tax at all would be paid, of course.

We have taken to illustrate the effect of this tax, the relatively high income year of 1930, and the common stock earnings of five outstanding American corporations. It must be remembered that these examples are merely illustrative and do not provide an accurate measure for all companies, nor even for these companies in any other year. The table follows:

Effect of Graduated Corporation Income Tax upon Earnings
Applicable to Common Stock for Selected Industrial Corporations

Corporation	1930 reported earnings per share common	1930 earnings adjusted for 1934 tax rate	1930 earnings adjusted for graduated tax 1/	Decline due to graduated tax	
				Amount	Percent
Corporation A	$ 9.12	$ 8.93	$ 8.52	$ 0.41	4.6
" B	1.65	1.63	1.60	.03	1.8
" C	8.08	7.91	7.54	.37	4.7
" D	3.12	3.09	3.03	.06	1.9
" E	4.46	4.41	4.30	.11	2.5

1/ Using rates in Table on Page 1 hereof, estimated to yield $102.2 millions of additional revenue.

Sources: Moody's Industrials for number of common shares and published earnings per share;
Bureau of Internal Revenue for corporation income tax liability.

Treasury statistics show sources of income, such as dividends and show the importance, relative to total income, of the various sources. The largest total amount of dividends reported as being received by any income class, according to the preliminary report for 1933, is that received by those under $5,000 of net income, but the relative importance of dividends to total income is least in this class, and the relative importance of dividend income is upon an ascending scale as we climb the income brackets. Thus to those under $5,000 of income dividends on the average contribute but 5.07 per cent of their total, while 50 per cent of the total net incomes over $1,000,000, is derived from dividends. A table, showing the relative importance of dividends and wages and salaries in various income groups is as follows:

Relative Importance of Dividends to Various Income Classes

1933 Preliminary Report, Statistics of Income

Net Income Classes	Total Net Income	Dividends on Stock of Domestic Corporations	Dividends — Percent of Income	Wages and Salaries	Wages and Salaries -- Percent of Income
Under 5,000	$8,125,000,000	412,000,000	5.07	5,407,000,000	66.55
5,000 - 10,000	1,854,420,000	220,044,000	11.87	937,923,392	50.58
100,000 - 150,000	158,571,204	64,530,595	40.70	25,269,379	15.94
500,000 - 1,000,000	72,586,000	43,345,000	59.72	2,326,817	3.21
Over 1,000,000	99,015,000	50,283,717	50.78	2,761,338	2.79

INTERCORPORATE DIVIDENDS

One of the very important recommendations made by the President is a tax on intercorporate dividends.

The simple method of accomplishing this is to withdraw, in part, the present privilege of tax exemption. Dividends received by a corporation are now wholly free of the corporation income tax unless received from a foreign corporation, or one not itself liable to the corporation income tax.

If this tax-free privilege were limited to 85 per cent of the income received from dividends, so that only 15 per cent of dividend income were taxable at corporation rates, the effect, under the present flat 13 3/4 per cent corporation income tax rate would be a tax on intercorporate dividends at the rate of 2.0625 per cent.

Assuming, however, the enactment of the graduated corporation income tax, the effective rate of tax on intercorporate dividends would depend upon the income tax bracket of the receiving corporation, and using the rates set forth for illustrative purposes earlier in this discussion, it would vary from $1\frac{1}{2}$ per cent for dividends received by corporations falling into the lowest bracket to 2.625 per cent for dividends received by corporations in the highest bracket.

If the same segment of income should pass through a number of corporations in its course from the original earning corporation to the final receiving individual, the intercorporate dividend

tax would be compounded for all corporations save one through which the dividend passed. In the case of some of the complex holding company structures the total might mount up to 8 or 10 per cent. The tax would mount in proportion to the pyramiding of corporate structures of the holding company system.

It is not possible, from data available in the Bureau of Internal Revenue, to present comprehensive and accurate examples of the effects upon common share earnings of such reduction from 100 per cent to 85 per cent in the present exemption from corporation income tax allowed to dividends received by corporations. The reason is that the forms in use by the Bureau for corporation returns were designed primarily to exclude dividend receipts by corporations from taxable income, rather than to set forth in detail the character and amount of such receipts.

On the basis of the available data, however, it is strongly indicated that the proposed reduction in the exemption would result in only a slight increase in the taxes paid per share of common stock in typical large corporations. For example: In the case of one large public utility holding company which has numerous subsidiaries which, in turn, have their own subsidiaries, it is estimated by the Bureau that, even on the basis of the liberal dividends paid to the company in 1930, the effect of the proposed reduction in exemption would have been only 12 cents per share

of the common stock. In the case of a large industrial corporation with many subsidiaries, the common share earnings in 1930, it is estimated, would have been affected by only 5 cents per share.

Dividends have long been a favored source of income to both corporations and individuals under our income tax law. On the theory that dividends were taxed when earned by the original corporation they have been made free of the individual normal tax. And on the theory that they would be taxed when distributed to the individual, corporate earnings have not been made subject to such high rates as are found in individual surtax brackets. The treatment of the two taxes presume that the corporate earnings will reach their ultimate owners promptly. So long as corporate earnings are retained by the earning corporation, or are passed about by corporations which receive them free of tax, the Government's tax on the earnings is far from effective. The basis upon which corporate dividends are given their present treatment as between individual and corporation taxes is removed and revenues are postponed when intermediate corporations are interposed between the ultimate individual stockholder and the earning corporation.

The secondary effects of an intercorporate dividend tax are extremely important. In tax enforcement, observations of social effects are only incidental and by no means comprehensive. It is, however, impossible to administer tax laws with open eyes and escape observation of some of the underlying conditions which would be secondarily affected by the intercorporate dividend tax.

We see examples of legitimate and almost necessary uses of subsidiary corporations by those whose operations are widely spread geographically. A nationally owned business may find it almost necessary, and certainly expedient, to have subsidiaries in different states, often to comply with the requirements of the several jurisdictions as to qualifications for holding property or franchises. The Treasury would not favor a tax which would bear oppressively upon such legitimate operations.

At the same time we see other uses made of subsidiaries. For example, the Public Service Corporation law in the State of New York prohibits a foreign corporation from owning more than 10% of the stock of certain utilities of that State. In 1928, one foreign corporation organized ten subsidiaries, each of which owns 10 per cent of the outstanding capital stock of one of New York's large operating utility companies, and, from an examination of the tax situation, no purpose whatever appears, except to circumvent the laws of New York.

Whatever the purpose to which these holding company systems have been put, outside of tax purposes, their effect on the revenue system is demoralizing and destructive of good administration.

The existence of these complicated systems has opened the door to operations which defeat stability of revenues, defeat enforcement, and multiply its costs.

The tax problems arising out of systems of holding companies, subholding companies, operating companies and mixed companies, are very serious. For example, one such system as of December 31, 1933 contained approximately 270 companies of which 128 were public utility operating companies located in several and widely separated states, and at least 31 of which would be classed as subholding companies. The corporation filed consolidated returns showing no tax due in any of the years 1929 through 1933. The system was not so modest about its profits in its reports to stockholders, and the Bureau began the task of audit. The auditing to date has required the services of 108 field agents for an aggregate period of 11,488 days, the services of 16 auditors for a period of 2,640 days, as well as the services of the supervising staff. The task is not yet nearing satisfactory completion. The investigation is complicated by the great volume of security transactions among the different companies of the group. In some instances securities were transferred through as many as ten intermediary companies on the way from starting

point to destination. A dollar of earnings would likewise run through several companies before reaching a resting place.

Some of these holding companies have imposed charges upon underlying operating utilities for the income tax liability which the operating companies would have paid if they had filed a separate return. Then by eliminating the profit through the consolidated return, no tax was paid to the Government. The holding company had collected the tax and kept it for itself. One company collected from its subsidiaries between 1926 and 1929 in excess of one and one-half million dollars on this basis. This particular device is probably now defeated by withdrawing the privilege of filing consolidated returns.

Elimination of consolidated income tax returns does not eliminate the necessity for auditing these gigantic systems, nor does it make the problem less difficult. Managements that are so disposed still find it possible to shift security transactions from one company to another for the purpose of allocating losses or profits so as to avoid taxes, and can still control and divert earnings from one to another unit in the form of service charges, accountancy, tax consultant and management fees, and by various other charges can so reduce taxable income of some units and increase net income of others that they can accomplish many of the results of consolidated returns.

It is almost impossible, with systems of this magnitude and complexity, to determine the tax status of many companies. And,

after an audit is made, the situation is easily and rapidly changed, to avoid its results.

In 1929, a certain corporation recorded on its books a capital gain in security transactions of $18,000,000 which was eliminated through a consolidated return. The Bureau found, however, that there was no lawful basis for the consolidated return, and the resulting tax was about $2,000,000. However, it was then discovered that a letter, written in 1933, purported to confirm what was claimed to have been an oral agreement made in 1929, although it had for years been left unwritten. By its terms the two companies declared their transactions to be continuing and not to be finally fixed and determined until all taxes were finally paid. The object of the device was apparently to prevent the closing of the transactions in 1929 and to throw the profit in whatever year was found to be convenient.

Corporations that are parts of such systems find it relatively easy to strip themselves of their assets and to leave the Government without an easy method of collection. In some cases transferee proceedings may be available to recover assets. In other instances they are extremely difficult. In one case a subsidiary exchanged bonds of the parent company for stock of the parent company on the basis of an apparent market value as of the date of exchange. The stocks received are practically worthless; the bonds still have some value. Transferee proceedings are difficult, to say the least, in reaching situations of this kind.

These corporations that are parts of such systems too often cease to be separate corporate entities. Their affairs become intermingled, their accountings confused and responsibility for their conduct separated in interest from the interests of the corporation itself and its minority stockholders.

Tax law has for some years encouraged and almost subsidized the growth of these systems. Stocks of our domestic corporations, when held by parent corporations, have had almost the same status as to the tax exempt privilege that the Government has given to its own securities. There was a distinct incentive to corporations to acquire investments in other corporations, and once acquiring investments, there were, of course, the usual incentives to acquire control.

Moreover, the privilege of corporate reorganization without recognition of a taxable profit often made it advantageous to effect consolidations or engage in other types of reorganization rather than to make sales outright.

The concentration of control of wealth has unquestionably proceeded at an even faster pace than the concentration of the ownership of wealth.

The concentration of control of wealth as distinguished from its ownership is not capable of statistical treatment with such accuracy as the concentration of ownership. The very purpose of corporate structures is to concentrate control by the management over the savings and earnings of the many stockholders, but of all forms, tax experience would indicate that the most vicious form of centralized control is that exercised through a system of pyramided corporations. Its opportunities and temptations are far greater than those that beset the management of a single unit. The shifting of profits from parent to subsidiary or from one subsidiary to another in which the management may have a greater percentage of stock ownership, or the transfer of assets in exchange for stocks with a resultant benefit to the corporation in which the management has a greater share of ownership, or buying from

and selling to controlled corporations, and market operations against the stockholders on inside information as to corporate structures which have grown too complex for anybody except the management to understand, are all matters which are forced upon the attention of those who have tax administration in charge.

So far as we can estimate, probable effects of a tax on intercorporate dividends would be these:

It would implement the graduated corporation income tax. If intercorporate dividends continue to be entirely exempted from taxation, there would be a powerful temptation for large corporations further to complicate their capital structures by organizing a series of operating subsidiaries, each one of which would be able to take advantage of the lower rates in the early brackets. This would not only defeat the purpose of the graduated tax, but would positively pervert it by further complicating capital structures already too complicated. This may be prevented by taxing the dividends which would be received from such subsidiaries sufficiently to offset any tax advantage which might be derived from their creation.

Even aside from any considerations connected with the graduated corporation income tax I believe that such a partial withdrawal of the exemption now extended to intercorporate dividends would be desirable as a means of encouraging the simplification of corporate structures. Intercorporate dividends are largely unnecessary transfers brought about and multiplied by complex corporate structures. There are many examples of these complicated corporate structures in the public utility field, but the same thing runs throughout the entire field of industry.

Up until last year the Federal Government had done little or nothing to discourage such needless complexities. Last year a definite step was taken in this direction by the abolition of consolidated returns. The partial elimination of the exemption allowed intercorporate dividends would be a further step in this direction and would have the effect of discouraging the multiplication of intermediate holding companies and of encouraging the creation and maintenance of straightforward capital structures that can be understood by the average investor and public official.

It should be borne in mind that the cost of this tax will be felt in proportion to the abuse, and that many corporations and systems would be able to reduce greatly or eliminate the tax by the simplification of their corporate structures. Such a movement would simplify enforcement and increase the revenue.

I cannot give exact figures on the volume of dividends received by American corporations that would be subject to this tax as our income tax statistics have not been compiled in such a manner as to make this possible. We have, however, compiled estimates from such figures as are available, and it is on the basis of these data that we estimated the probable yield from this tax. These figures indicate that the total amount of dividends paid by one corporation and received by another during each of the past several years has been as follows:

1931	$3,900,000,000
1932	2,100,000,000
1933	1,650,000,000
1934	1,750,000,000

For the year 1935, assuming a continuation of present corporate structures and practices, we estimate that this figure will be approximately $1,900,000,000.

We therefore estimate the yield from reducing to 85% the present 100% exemption of intercorporate dividends from the corporation income tax to be $39,700,000.

EXCESS PROFITS TAX

It has been suggested that the principle of the present excess profits tax be substituted for, or added to, the principle of the graduated tax on corporate income. The adoption of either does not exclude the other. They are not inconsistent in principle, and while the application of both would be complicated, it is by no means impossible. Each is an effort to measure the burden by ability to pay and each takes a different measure of ability.

Whatever may be the merits of an excess profits tax, they are not the merits of a graduated corporation income tax; and it is illogical to propose one as a substitute for the other.

As a revenue producer, the graduated corporation income tax is apt to be far more stable than an excess profits tax. The latter would be applicable mainly to unusual rates of profit, which are far less regular in their occurrence than corporation income as a whole.

Whereas a graduated corporation income tax, based upon size of income, recognizes the peculiar advantages of large business units in modern society, the excess profits tax would fall upon small and large concerns alike. It is notorious that the risks facing small concerns are generally far greater than those facing large business organizations. It follows that unusually high rates of profit for small concerns are often only necessary compensation for the risks that they face and for their frequent losses. If small concerns were not able to enjoy good years, they could not withstand the competition of their larger and more stable competitors during poor years. The greater

vulnerability of small corporations than large ones in periods of declining business activity has been mentioned.

The graduated corporation income tax, based upon size of income, is designed to recognize directly the advantages of size as a measure of ability to pay. An excess profits tax would not be affected at all by the size of the concern; a peanut vendor being made subject to it at the same rates as those that would apply to a giant corporation.

The enjoyment of high rates of profit by small concerns during prosperous periods enables them better to withstand the heavier risks to which they are subject; and makes possible their growth. We do not wish to discourage the growth of small concerns. It is the existence of healthy and profitable small concerns that gives our economy the elasticity and flexibility in production and prices that are so valuable.

It is not to be disregarded, also, that many of the services rendered by the Government are rendered corporations, directly and indirectly, according to their size, and not according to the rate of their profits. The mere maintenance of law and order, the regulation of transportation and communication systems, the provision of uniform currency and banking arrangements, and many others are of value to business corporations roughly according to their size.

The present excess profits tax law has not been upon the books long enough to form a final judgment of its merit. It has been there long enough to develop some of its defects.

Capital stock tax returns filed under the present law have not been subject to a review as to their initial declaration of value. The capital stock tax collected for the year ending June 30, 1934 was $80,000,000, which indicates a declared value of $80,000,000,000. Under the income tax law we collected, during the same period, approximately $400,000,000, which at 13 3/4 per cent would indicate a corporate income of $2,909,000,000 or a return enjoyed by all corporations of about 3 5/10 per cent on the aggregate declared value. Capital stock returns, however, were made by a considerable number of corporations which reported no net incomes for the year, and eliminating those would tend to increase the percentage of net return of corporations having income.

The excess profits tax paid during the fiscal year ended June 30, 1934, was approximately $2,600,000, which would indicate the declared values were insufficient by $416,000,000 to render corporations exempt from excess profits tax if they had declared sufficient value in their original capital stock tax returns.

It is evident that taxpayers are inclined to declare their capital stock tax value solely upon their expected net income rather than upon the basis of the true value of the capital stock as reflected in the capital invested in the business.

Two comments should be made on the excess profits tax as it now stands. Net income subject to excess profits tax does not include dividends. Therefore, the corporation whose income is made up of dividends from another corporation may declare a low valuation without subjecting itself to liability for excess profits tax. One company into which assets of about $90,000,000 were transferred, declared a value upon its stock, for the capital stock tax, in the amount of $1,000,000. As the income of this company consists principally of dividends, this absurdly small valuation is safe from an excess profits viewpoint. Many examples could be cited to show the advantage thus given to holding companies as against operating companies in the present capital stock tax law.

If a corporation has underestimated its net income, and in trying to keep to a minimum its capital stock tax, has subjected itself to heavy excess profits tax, there is nothing in the statute

to prevent a nontaxable reorganization being effected on a basis that will permit a new declaration of value and escape from the future heavy excess profits taxes.

It has also been suggested that the principle of the war-time excess profits tax be combined with or substituted for the graduated tax on corporate incomes.

This tax was of outstanding importance during the War and was afterwards abandoned, and the effort to base it upon the realities of excess profits led to difficulties in administration which were chiefly responsible for its abandonment. The present law, is actually a capital stock tax with an incidental excess profits tax feature of enforcement. The insignificant revenues from the excess profits tax provision in 1934, amounting to only $2,600,000, indicates its incidental character as compared with the capital stock tax which yielded approximately $80,000,000 during the same period.

It must be borne in mind that the unfortunate administrative experience with the real excess profits tax began at a time when the Treasury was struggling with an income tax itself only six years old.

It does not seem necessary at this time to discuss the war time excess profits tax experience and possibilities. While the administration of such a tax has been difficult, its problems do not necessarily forbid this type of taxation today.

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